

attempt to explain in simple terms the recent, well publicized, accounting abuses that have surfaced in corporate America and to propose possible reforms to deter such abuses in the future.

II. Addressing issues 4 and 5

“What lessons can be learned from other regulatory accounting requirements, including those requirements, if any, used by such agencies as the Securities and Exchange Commission, the Federal Energy Regulatory Commission, the Federal Trade Commission, the Department of Justice, the state Attorneys General and Secretaries of State?”

“What is the role of regulatory accounting at the present stage in the movement from a regulated monopoly towards an increasingly competitive communications market?”

There seems to be some characteristics of the telecommunications industry that has rendered it particularly susceptible to the kinds of accounting and financial abuses that have occurred. Observing these abuses, and the reforms proposed to date by other standard setting bodies, I am concerned that some fundamental issues are not being addressed. Financial reporting has been materially manipulated under Generally Accepted Accounting Principles (“GAAP”). GAAP has failed us. This is an unprecedented era of bankruptcies and loss of investor confidence. I have thought about how the fundamental principles of GAAP could be reevaluated and clarified. I have developed four principles that would fit within the conceptual framework of GAAP and would deter these abuses. Those are: (1) financial reports should first and foremost rely on objectively verifiable criteria; (2) intangible assets should not be included in financial reports; markets should be the entity that values all intangible assets; (3) auditors should not evaluate risk; auditors should certify factual information so that users of financial reports can assess risk; and (4) when balancing accounting principles, financial reports

price unbundled network elements (UNEs), federal universal service forward-looking cost models, and

should be made most reliable for the key measures that financial analysts rely upon most heavily.

I will show how these four principles could be applied to three of the major areas of accounting abuses; those being (1) revenue reporting, (2) capitalization policies, and (3) off-balance sheet financing. I will explain how the existing accounting rules have allowed these abuses to occur, and I will explain how applying these revised principles would greatly deter these abuses in the future. I view such a reevaluation of principles as necessary to counter balance the inherent conflict of interest that results from companies hiring and paying their own auditors, even with the statutory new auditor independence requirements.

With regard to accounting reforms, initiatives ideally should come from the standard-setting bodies of the entire accounting profession. However, access to capital is especially critical to the telecommunications industry right now. Many of these failed companies are in the telecommunications industry. The telecommunications industry is capital intensive. Access to capital markets is essential to maintain infrastructure, to assure the continued provision of quality utility service, to support innovation in new technologies, and to enable the transition to competitive telecommunications markets to move forward.

The particular causes of failures by companies in this industry need to be evaluated now and these particular types of abuses need to be addressed. The Federal Communications Commission (“FCC”) has authority to set accounting requirements for competitive providers as well as for incumbent local exchange carriers. I will present proposals that reform accounting rules to address these abuses and could be adopted by

various other projects related to the transition to competitive telecommunications markets.

the FCC. My proposals would need to be applicable to competitive providers for accounting reforms to apply to companies like WorldCom, and Qwest Communications, to name a couple companies whose accounting abuses have shocked all of us.

III. Addressing issue (7)

“Whether the FCC and/or the states should increase their financial monitoring of any telecommunications carriers, including incumbents or competitive carriers. If so, what additional accounting requirements would be appropriate?”

These comments will address the following areas of recent abuses: (1) revenue reporting, (2) capitalization policies, and (3) off-balance sheet financing. If there is support for my approach, then further work can be done to identify other areas for improvement where financial reporting has been materially manipulated under GAAP’s existing accounting rules.

Revenue Reporting

Revenue recognition

Revenue recognition refers to the time period in which revenues are recorded. Applying accrual basis accounting attempts to match revenues with the period in which they are earned. However, companies have structured sales contracts based on the desired appearance of revenues in their financial statements. Companies have developed forms of contracts which make it difficult to associate revenues with appropriate time periods. Companies have moved forward the amount of revenue reported by pursuing more sales with long-term contracts giving a fictitious appearance of sales growth. In light of the nature of the services provided, the telecommunications industry is particularly vulnerable to this form of abuse.

I propose a change that is simple and can be implemented quickly to restore public confidence. I propose requiring both cash basis reporting of revenues and accrual basis reporting of revenues. This would be parallel reporting. Accrual basis reporting has its merits, but it requires the existence of detailed rules regarding when revenue should be recognized. While revenue recognition rules should be tightened up and efforts are in progress, a quick and easy way to provide additional useful information would be to show sales on both a cash basis and an accrual basis. Unlike expenses, for which management has discretion over what to pay or not pay, management has little discretion in recording when cash payments have been received. In combination, these two methods of reporting will provide better information to evaluate growth. If growth substantially differs between these two forms of reporting, investors would be given a signal to look deeper with their analysis. Revenue and earnings growth are two key measures that financial analysts rely on. As these measures are of such importance, it is imperative that audit reports provide the most reliable information possible for these measures. Parallel presentation of cash basis revenues would provide useful verifiable information.

Facilities Swaps

In addition, there needs to be a stop to another particularly misleading type of transaction engaged in solely to affect the appearance of increased revenues. These are facilities (or capacity) swaps. A facilities swap is when two companies own similar facilities and agree to exchange them by selling them to each other at inflated prices. After such a swap, both companies report increased earnings on the sale of their facilities at a gain, while at the same time inflating the value of their facilities on their own

financial statements. Qwest Communications restated its earnings to, in part, eliminate swaps that it engaged in.

This is an old trick now reappearing in a new form. In the 1930's, companies within a utility holding company system sold their facilities back and forth to inflate the value of their facilities and overstate their earnings. All the companies were part of the same holding company so they would easily agree to such sales. Now what we are seeing is two unrelated companies doing the same thing in a "you scratch my back, I'll scratch yours" arrangement. These are not independent third party transactions. Swaps are a collusion to mislead investors and current accounting and auditing rules are not catching or preventing them.

Under rate of return regulation, regulators developed rules that prevented such an abuse. Only the original cost of facilities when first placed in service can be included in the plant accounts and for that portion of a purchase price above the original cost, utilities have to get specific approval before it can be included in rate base. However, today, many utilities are not subject to rate of return regulation, and this former technique does not apply.

Accordingly, I propose a similar solution: require the same differentiation between the original cost when facilities were first placed into service and that portion of a purchase price above original cost for utilities that are not subject to rate of return regulation. In addition, the portion of a purchase price greater than the original cost when facilities were first placed in service should be recorded as an expense. This type of reporting would alleviate the need to determine whether two transactions were so proximate in time or nature to effectively be a swap. Expensing any amount of a

purchase price greater than original cost when first placed into service would eliminate both the inflated plant values and the overstated earnings. Earnings could not be manipulated with swaps if this form of accounting was required.

I know there are many who will object strenuously against this proposal. This will increase the level of reported expenses when one company buys another company or its facilities. However, I don't think I can overemphasize my concern that this is the same abuse that led to the collapse of many holding companies in the 1930s. We are seeing history repeat itself. Utilities with their large capital investments are particularly vulnerable to this abuse. It is now manifesting itself outside of holding companies and needs to be addressed quickly and decisively to prohibit this form of deception.

Capitalization Policies

Capitalization refers to the practice of recording an expenditure with a life of greater than one year as an asset on the balance sheet rather than as a current-period expense. The declining value of the asset is then recorded as depreciation expense over a period of time. This differs from recording an entire expenditure as an expense in the year incurred. Accordingly, criteria regarding capitalization have a significant impact on the reported net income for any period. However, under GAAP there are some expenditures that would seem to benefit future time periods that are required to be reported as an expense, such as research and development. At the same time, there are other expenditures, like the purchase of business for more than the value of the piece parts that gets capitalized as goodwill. The WorldCom situation was a case where a company capitalized over nine billion dollars that should have been recorded as an

expense. WorldCom treated certain right-to-use fees as intangible assets that it could capitalize.²

This abuse is similar to facilities swaps. It inflates the value of assets and overstates earnings. In a similar vein to my proposal to address swaps, I propose that only physical assets should be allowed to be capitalized.³ Again some people may claim this proposal is heavy handed, but it would deter an abuse like that of WorldCom. With hindsight, it is clear that WorldCom violated the accounting rules. However in my opinion, there is something very wrong with the existing accounting rules. They were interpreted in a manner to shift nine billion dollars from expenses to investments, and when revealed, lead to the immediate bankruptcy of a company. My proposal to only allow physical assets to be capitalized would deter such action and would fit into a larger conceptual framework covering the valuation of all assets in financial reports.

When one looks to the history of accounting, there is precedence for a distinction based on physical versus intangible assets. When existing accounting rules were developed soon after the holding company abuses of the 1930s, there was great debate whether to use “fair value” in financial reports or whether to use the actual purchase price. Accountants ultimately chose to use the actual purchase price and since then accounting has been based on historical costs. Accountants fully realized in making that choice that when general price levels are increasing, the valuations will become out of date. However, the use of historical cost was adopted due to its inherent reliability and

² The right-to-use fees were fees that were paid to third parties for access to their networks. WorldCom capitalized their monthly payments for excess capacity.

³ There is an exception to this rule for rate making purposes and determining universal service support based on embedded costs. For purposes of intergenerational equity, a regulatory body should be able to defer an expense and create a regulatory asset by providing a reasonable opportunity for recovery in future revenues, which is covered under the current FSAB 71 rule.

lack of subjectivity. Using historical costs, the same conclusion regarding value would be reached by two or more qualified persons examining the same data. Changing the rules to only capitalize physical assets would have the same inherent reliability and lack of subjectivity.

However, existing accounting rules, while still relying on historical costs, now at times have incorporated fair value determinations. One example is the purchase of a business. Accountants determined how much of the purchase price is related to the fair value of the assets acquired and how much of the purchase price should be considered to be goodwill. I believe accounting rules should use more objective criteria, capitalizing only physical assets at the original cost, rather than a subjective determination of fair value. This would eliminate the mix of valuation methods that exist in current accounting rules and would deter an abuse like that of WorldCom. Fundamentally, if accounting rules are going to rely on historical costs due to its inherent reliability and lack of subjectivity, then it should apply that principle consistently throughout its rules.

The use of original cost and only capitalizing physical assets, would also clarify that the market should be the entity that values all intangible assets. GAAP already relies on the market to value some intangible assets. This valuation method provides the theoretical justification for recording research and development (R&D) costs as an expense. Using the example of the development of a new drug, as soon as investors have reason to believe an important new drug will receive approval from the Food and Drug Administration, the stock price dramatically increases. This effect will occur regardless of whether R&D costs have been recorded as expenses or investments. Existing accounting rules require R&D costs to be recorded as expenses as accountants are not

able to reliably determine its worth. For this type of cost, accounting rules already rely on the market to value R&D.

There should be an equal concern about the reliability of the valuation of all intangibles assets. Intangible assets do not need to be shown on a balance sheet to recognize their value. The existence of an intangible value is reflected in its effect on earnings. For example, one reason a business might be purchased for more than the value of its physical assets would be to obtain the customer base that company holds. The value of the customer base will be reflected in its effect on sales. When there are intangible values, investors are willing to pay more for a stock. Investors are compensated for the cost of intangibles through higher prices for a company's stock.

Accordingly, it is reasonable to use the same mechanism that values R&D to value all intangible assets. This is not to argue that one profession, auditors, management consultants, or financial analysts is more or less qualified to determine intangible values. I propose such a distinction in order to make it clear where such subjective valuation is performed. When accountants value intangible assets, such valuations are not likely to be performed consistently from company to company and year to year and ultimately allowed an abuse like WorldCom's to occur. The premise of my proposal is that it would be a better fundamental principle to always record intangible assets as expenses and to let the market determine the valuation of intangible assets in their entirety.

Off Balance Sheet Financing

Investors use information on the relative amounts of debt and equity that a company holds to evaluate the riskiness of an investment. The concept is similar to that of the size of the down payment when getting a mortgage for a house. The risk of default

is less when there is a larger down payment for two reasons. One is that the size of the mortgage will be smaller. The other is that having a larger down payment demonstrates the ability of the borrower to accumulate that amount of money. On a balance sheet, the assets would include a house; the liabilities would include a mortgage; and owner's equity is like the down payment. Investors use the balance sheet to evaluate financial risk. Investors need complete and accurate reporting of the amount of debt in order to assess risk.

Sales of Securitized Assets

Special purpose entities have been created which result in debt that is not reported on the balance sheet. To explain how debt is not reported, I will describe a fairly complex sequence of transactions. At the end of that discussion I will connect the name "Securitized Assets" with the sequence of transactions that I describe.

Increasingly, companies have "sold" future revenue streams such as franchise fees or future collections of accounts receivable. Throughout this discussion, I will use selling accounts receivable as an example, but the same techniques have been applied to many forms of sales of future cash receipts. Through the use of a corporate shell game (special purpose entities) such "sales" have in reality been nothing other than a way of obtaining a loan without reporting it on the books of the company, i.e., off-balance sheet debt.

A shell company is set up with nothing more than a token amount of outside investment to make it look like an independent entity. The shell company then sets itself up as an intermediary to buy the accounts receivable through taking out a loan to have the cash for the purchase. However, when the shell company "buys" the accounts receivable, it also receives a guarantee from the selling company that the accounts will be fully

recoverable or will only experience a stated limited quantity of uncollectible accounts, thus assuring that it will have the funds - from the collection of the receivables - to pay off the loan. So the company “selling” the accounts receivable really still holds all the risk that there might be so many uncollectible accounts that the loan could not be repaid from their collection. The transaction is referred to as the sale of “Securitized Assets” as the future cash receipts have been packaged and sold like a form of marketable security similar to treasury bills.

By comparison, a company can obtain a loan using its accounts receivable as collateral. In such a transaction, a company gets cash; however, the accounts receivable still appear on its balance sheet and the money received appears as debt on the balance sheet.

The accounting rules have been written to allow the accounting treatment which moves the debt off the books. The accounting rules that allow the use of off-balance sheet financing require a “token” three percent independently invested capital in the shell company for it to be viewed as a separate entity and not so influenced by the selling company that it should be viewed as one in the same. Accountants have told those involved in the transaction to obtain the three percent independent capital to get the reporting they desire.

This particularly makes my point that accounting rules should be written to limit the extent to which the rules can be used to manipulate financial reporting. Auditors, instead of fulfilling their roles as independent verifiers of fact, instead have taken on the roles as the guides who provide the information as to where the accounting loop holes are located and how far they can “legally” be stretched.

Many will argue that there are important business purposes to the use of special purpose entities. One example would be to obtain a lower interest rate on a particular loan. However, when there are legitimate business purposes for these transactions, there should be no objection to reporting the debt.

The Securities and Exchange Commission (“SEC”) has recently adopted rules for disclosure of off-balance sheet arrangements. However, these rules continue to give auditors discretion to determine whether debt needs to be reported. The rules call upon auditors to make an evaluation of the degree of remoteness that a triggering event will occur. Using the above example of accounts receivable, this would mean the auditor would evaluate how likely it would be that the selling company would have to make payments on the guarantees in order for the shell company not to default on the debt. Under the SEC rules, if the auditor thinks the likelihood is only remote, then the off-balance sheet arrangement would not need to be reported. In my opinion, a rule written in this way is highly unlikely to give the same results when two professionals review the same data. This still puts auditors in the position of deciding whether an arrangement is risky enough that investor should even be told about it.

The Financial Accounting Standards Board (“FASB”) has taken a slightly different approach. The FASB has also recently issued rules covering what it calls Variable Interest Entities. These rules address what I described above as the “token” investment. Where the former percentage of investment required was three percent, the FASB has raised that percent to ten percent. My concern is that just raising the percentage of “token” investment required still has the potential to have a large liability that is not reported on a company’s balance sheet.

I would reverse the approach taken by the SEC and FASB. I suggest not setting a threshold to be used as a basis for determining whether an off-balance sheet liability needs to be reported or not. I would have the relative amount of debt reported vary with the amount of “token” investment. If the token investment was 3 percent, then I propose only 97 percent of the cash received should need to be reported as debt. If the token investment was 10 percent, then only 90 percent of the cash should need to be reported as debt. This form of reporting would more closely track the substance of the transaction. It is the *de facto* level of debt that has been incurred. The financial reporting would mirror the reporting that would result if the receivables were simply collateral and not placed in a special purpose entity. This should apply whenever future cash receipts are sold with some form of guarantee. I believe conceptually, there should be full inclusion on the balance sheet of all off-balance sheet liabilities. Other types of off-balance sheet financing should be identified and examples developed to show how it can be reported as debt on the balance sheet.

In my opinion, auditors should not assess risk to determine whether or not to report debt. Audit reports should provide factual information regarding the amount of debt so that users of financial reports can assess risk. Off-balance sheet financing led to the collapse of Enron and is believed to be very prevalent in the telecommunications industry. However, at this time the magnitude of debt not reported on the balance sheet is unknown due to its nondisclosure. Accounting rules are needed to provide full balance sheet disclosure of all this activity.

Principles-Based Accounting

The FASB has a proposal and has requested comments on a “Principles-Based Approach” for accounting rules. Indeed, the Sarbanes-Oxley, Public Company Accounting and Investor Protection Act, requires the SEC to conduct a study on the “adoption by the United States financial reporting system of a principles-based accounting system” and to submit a report to Congress by July, 2003. International accounting standards rely on such a Principles-Based approach. A Principles-Based approach would shift the emphasis of accounting rules from specific requirements and detailed implementation guidance to, instead, including greater explanation of underlying principles. I believe this approach is desirable in concept, as long as the principles developed move toward greater use of objectively verifiable criteria and away from including subjective valuations in certified financial reports.

The FASB proposal does not provide any details as to how the underlying principles will be identified. It simply points out that the existing conceptual framework for GAAP is not internally consistent and a Principles-Based approach would need to be internally consistent. My proposals provide an example of Principles-Based rules that are internally consistent. It proposes that financial reports should rely primarily on objectively verifiable criteria where two professionals reviewing the same data are highly likely to reach the same conclusions. It proposes that intangible assets should not be included in financial reports, and markets should be the entity that value intangible assets in their entirety. It proposes that auditors should not evaluate risk; auditors should certify the accuracy of factual information so that users of financial reports can assess risk. It proposes that when balancing accounting principles, financial reports should be made

most reliable for those key measures that users of financial reports rely upon most heavily.

Confusion between the role of auditor and the role of analyst has contributed to the market boom and associated bust we have experienced. Management knows that financial analysts place a greater value on growth in earnings as opposed to steady earnings. Management has searched for ways to show earnings growth trends even where economic activity has been stable or declining. As the extent of earnings growth is a key piece of data that financial analysts watch, accounting rules should be developed that provide assurance that the appearance of earnings growth will be real and not illusory. My proposals should limit the ability to manipulate reported earnings. Additionally, in light of the use of historical costs in financial reports, book value per share is the least important measure in financial reports. My proposal balances contradictory principles by sacrificing completeness in valuing worth in order to provide more consistent and reliable financial reporting of earnings.

Quantitative evaluations of the worth of a company are important, but there are other contexts in which this information can be provided. Techniques for valuing future revenue streams, and intangible assets, as well as evaluating risk are important managerial tools but they require certain subjective assumptions to make these calculations. Such information is particularly applicable to making business operating business decisions. In that application, the accuracy of such analysis would be confirmed or discredited based on the quality of the business decisions it supports. This is an appropriate context for this kind of analysis. Another appropriate context for such analysis could also be in a more extensive management narrative discussion in financial

reports to help investors understand the value of a company. Management could provide discussion of intangible assets and support the proposed values with a variety of techniques useful in determining economic value. However basing the actual financial reporting on objectively verifiable criteria will improve consistency and reliability financial reports.

The accounting profession needs to decide the purpose of certified financial reports, and to write rules that consistently implement that purpose. Either audit reports are intended to be an objectively verifiable certification of the consistency and reliability of the reports or a subjective evaluation of a company's worth. They cannot be both.

Next Steps

While it would be preferable for accounting reform to be enacted by regulatory bodies whose rules are applicable to the entire accounting profession, time is of the essence for the telecommunications industry. Access to capital is critical to the transition from former monopoly regulation to reliance on competitive markets. Accordingly, I suggest a two-pronged approach; (1) to influence reform through profession-wide regulatory bodies and (2) to move forward on reforms critical to the telecommunications industry.

A copy of these comments has been sent to the SEC referencing File No. S7-42-02 (Off-Balance sheet disclosures) and the FASB referencing 1125-001 (Principles Based Approach). Unfortunately, the comments will likely arrive too late to be considered in a first round of rulemaking with either the SEC or the FASB. I am aware that there is some support for the use of objectively verifiable criteria, as opposed to determinations of fair value. However, unlike the FCC's electronic comment filing

systems which provides internet access to all electronically filed comments, the FASB and SEC do not have systems that provide electronic access to the comments filed by others. Accordingly, it is difficult to evaluate the extent of such support, how well it has been articulated, and whether this approach is being given serious consideration or not. I urge the members of the Joint Conference, if they find merit to these comments, to call the comments to the attention of those working on the SEC and FASB rulemakings and additionally to write their own supporting comments.

Additionally, I urge the Joint Conference to move forward with necessary reforms. I urge the Joint Conference to further develop rules from the concepts I have presented.⁴ I would suggest that those rules should be applicable to publicly traded companies subject to the FCC's jurisdiction. In light of the costs associated with two forms of financial reporting, I would not apply the rules to companies that are not publicly traded, as it is access to capital markets that is the pressing concern that I believe warrants immediate actions. I would suggest the use of supplemental schedules included with publicly traded companies' required financial reports.

I urge the FCC to develop rules based on the principles I have discussed. Based on those principles I made the following proposals.

- (1) Require parallel reporting of revenues on both a cash and an accrual basis.
- (2) Expense that portion of an asset purchase which is above the original cost when first placed into service.
- (3) Capitalize only physical assets. Expense all intangible assets.
- (4) Record as debt, any sale of guaranteed future cash receipts to the extent the acquiring entity uses debt to make the purchase.
- (5) Develop standardized reporting for other forms of commonly used off-balance sheet financing based on the principle of full inclusion on the balance sheet of all off-balance sheet liabilities.

⁴ These comments have primarily been written to try to be understandable by non-accountants. I would also be interested in further developing specific language for actual rules.

While not frequently exercised, the FCC does have the authority to require specific forms of financial reporting beyond GAAP. As the telecommunications industry has so much at stake in having accounting rules revised, I believe it would be appropriate for regulators to take a lead and help restore investor confidence.

Dated at Madison, Wisconsin, January 29, 2003

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